Can Sherritt Capitalise on Cuba’s Capitalisation?

Frankly the management of Sherritt, since way back, have not been seen as amongst the sharpest knives in the drawer. While they have rightly been obsessed with their *persona non grata* status in the US due to their supposedly falling foul of the wretched Helms-Burton Act, they have largely taken the ball off the means by which they could remake the company to maximise value for the long-suffering shareholders.

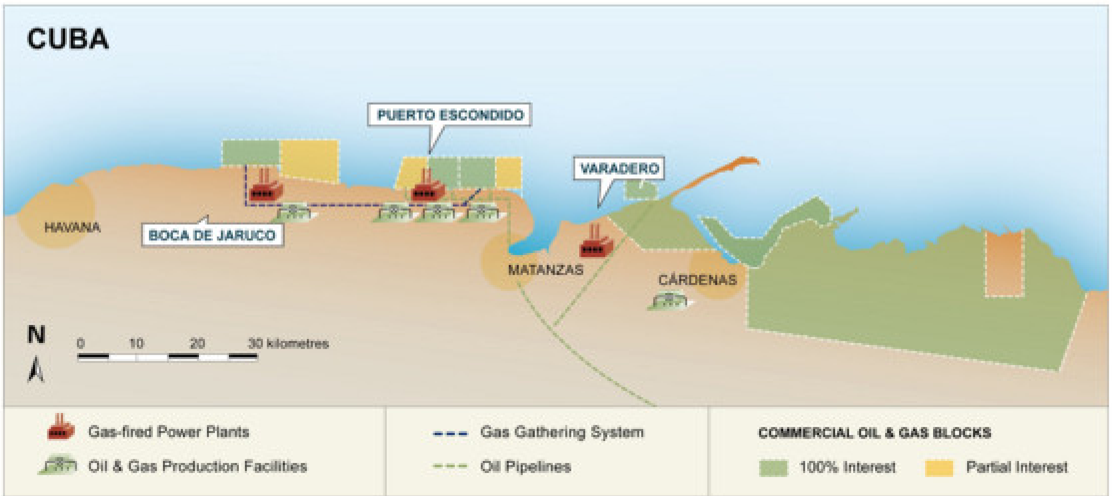
Here I shall examine the rather dire handling of the matter of the scarcely-known energy assets the company holds in Cuba, which are NOT subject to Helms-Burton problems but are being largely ignored as the country barrels towards a Vietnam-style “opening to the West”. The obvious solution is to demerge these assets and let them evolve as potentially one of the purest play entry points for emerging market investors into this nascent frontier market.

Electricity generation

One of the interesting positions that Sherritt has built up using its non-remittable funds in Cuba has been its push into electricity. This division has an internal logic in that Sherritt also has an interest in natgas production in Cuba. The company is also pushing into power generation in Madagascar in association with its Ambartovy project.

Sherritt holds an indirect one-third interest in Energas, a joint venture established to generate electricity for sale to the Cuban national electrical grid. The remaining two-thirds interest in Energas is held equally by two Cuban agencies, Union Electrica and Cubapetroleo. Energas runs a power generation system with 506 MW of gross production capacity with generation derived from gas supplied from Cuba’s north coast by Cubapetroleos.

Energas produces around 12% of Cuba’s total power output. The location of the plants and their individual capacities are shown on the map below.



Sherritt financed, constructed and commissioned each of the integrated gas treatment and power generation facilities located near the Varadero, Boca de Jaruco, and Puerto Escondido oil fields.

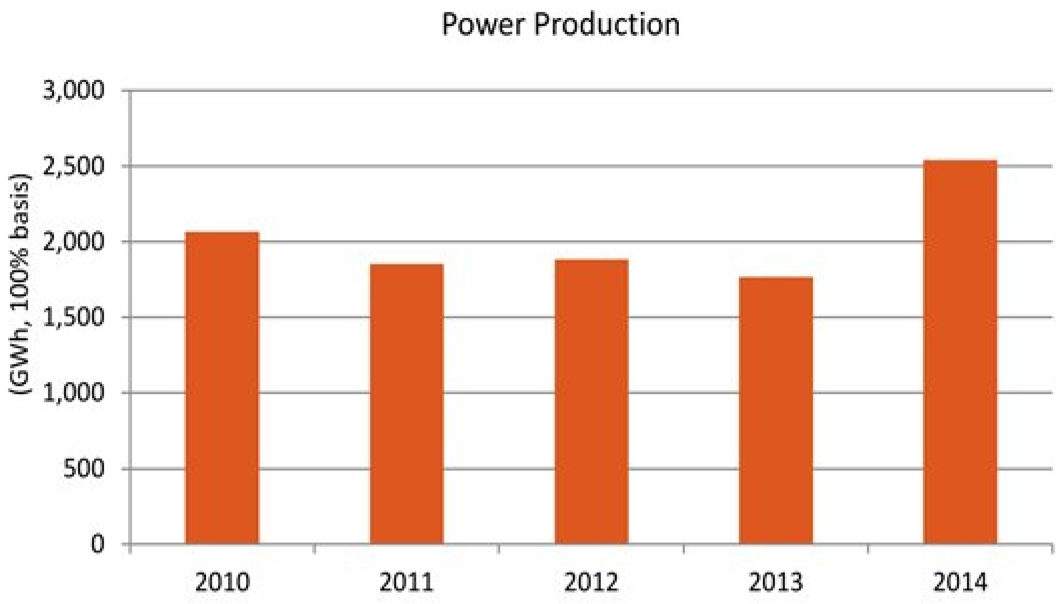
The Varadero facility is located approximately 140 km east of Havana. The facility consists of two integrated raw gas processing plants, three gas turbines and associated electric generators, a heat exchange system for generating high-pressure steam, and a steam turbine and associated electric generator. In addition, the Varadero site includes an electrical substation and transformers, to facilitate connection of the facility to the Cuban national grid, and an integrated maintenance and administration facility. Aggregate net power capacity of this facility is approximately 329 MW.

The Boca de Jaruco facility (pictured below) is located 50 kilometres east of Havana. The site initially consisted of a sour gas processing plant, one gas turbine and an associated electric generator with a net power capacity of 33 MW. The site also includes an electrical substation, a transformer to facilitate connection of the facility to the Cuban national grid and an administration facility. The facility commenced operation in August of 1999.

The 85 MW Phase 6 expansion of the Boca de Jaruco facilities completed in 2006 included the installation of two additional gas turbines and associated electric generators at the Boca de Jaruco plant site with a net power capacity of 65 MW and a third gas turbine and associated electric generator with a net power capacity of 20 MW located at a new plant site in the Puerto Escondido oil field. This phase of the expansion also included the installation of sour gas processing facilities at the Puerto Escondido plant. The Phase 7 expansion of the Boca de Jaruco facilities completed in 2007 included the installation of two additional gas turbines and associated electric generators with a net power capacity of 65 MW.

Then the company embarked on a project to expand capacity to 150MW via a combined cycle plant which came online in February 2014.

Depending on the availability of gas reserves, Sherritt could add a second 70MW phase.



Obviously as economic activity rises in Cuba then electricity consumption will rise. The chart above shows production by Sherritt’s Energas soaring. Indeed since last year these have risen even further. In the September quarter sales were 30% higher in dollar value than the same quarter of the previous year. They were up 23% in the nine months over the same period in 2014. Realised prices were up 20% also showing that demand is leading to firmer prices.

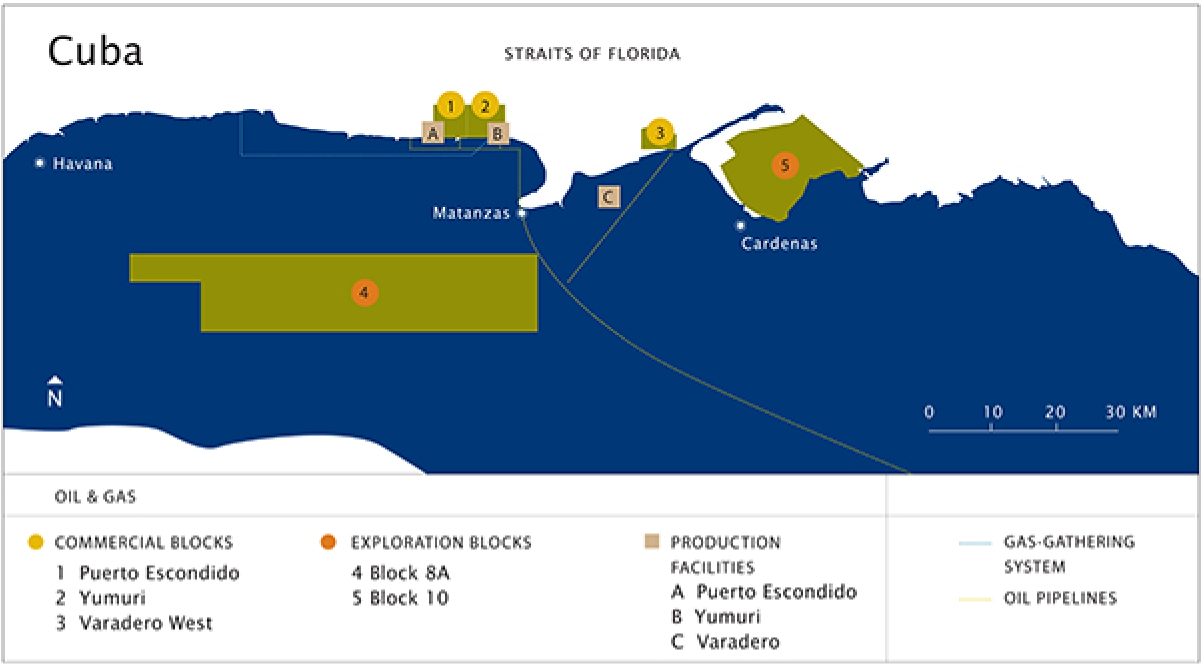
Results in electricity

One gets the feeling that Sherritt is “hiding its light under a bushel” in its energy divisions. Why it should do this is anyone’s guess. It reports high losses despite the EBITDA soaring. The electricity business made adjusted EBITDA of $24.5mn in the nine months to September 2015 (compared to $19.4mn in the first three quarters of FY14). Total revenues were $39mn (compared to $37.31mn). Cash provided by operations was $55mn.

Oil & Gas assets

Sherritt has interests in oil & gas fields in Cuba (as well as Spain and Pakistan, though those make up less than 4% of sales in the division). Its Cuban oil joint venture is juicier than its nickel. Average gross working-interest production in the first nine months of 2015 for the Cuban JV was 18,666 bopd (down from approximately 20,164 bopd in 2012). This makes the JV the largest domestic oil producer in Cuba, representing half of total production. Production had been even higher until early 2009 when the company was compelled to surrender its position in one producing block.

The company has production-sharing contracts for four offshore exploration blocks and vertically integrated operations, with seven production sharing contracts in the deepwater zone in the Gulf of Mexico northwest of Havana. These blocks cover approximately two million acres with proven and probable reserves of 50.5 million barrels. The oil in Cuba is located about 1,500 metres below sea level and it drills directional wells up to 5,600 metres long to pump oil to the surface.



With $132.1mn in revenues in the first nine months of FY15 and $219.7mn in the same period of FY14, the EBITDA so far in 2015 was $72.2mn (compared to $165.6mn in the same period of FY14) the Cuban oilfield business remains highly lucrative for Sherritt. It’s worth noting that the unit operating costs were $9.04 in Cuba compared to $43.8mn on the Spanish fields. This shows that Sherritt dropped the ball on selling the Spanish assets when the market was hot. Will it miss the ball on realizing the Cuban assets while the demand for exposure to that economy is so heightened.

Conclusion

In coming back to review Sherritt's energy assets in Cuba, we went back to the research piece we wrote on this theme in 2009. We then went to the latest MD&A on Sedar for Sherritt. The shocking thing is that the asset base of these divisions has been virtually unchanged since that time. The division neither got larger nor smaller, only the numbers fluctuated with tariffs, demands and prices for oil & gas. The "orphan" O&G assets in Spain and Pakistan still made up less than 4% of the total. Any other company in the space would have ditched such small participations to focus management effort and reduce costs of travelling such great distances. Clearly Sherritt doesn't mind being spread too thin.

The Cuban power plants, being *de novo*, are relatively secure from rapacious émigrés (not that not having title would ever stop them wanting them). A scenario worth pondering is Sherritt either floating them off should a Havana Stock Exchange come into existence. They would be prime fodder for such a new market. Another possibility would be Spanish majors in the construction/utility space snapping them up in the nearer future to get positioned for an eventual wider opening of the economy.

With the rapid opening of the Cuban market to Western investors there is obviously a hunger for exposure to this emerging (or frontier) market. Investors in the EM space usually pay sizable premiums for exposure. Clearly they are not going to buy Sherritt shares with its overwhelming preponderance to Nickel and Cobalt to get leverage into an opening Cuba. What such investors (Templeton being a good example) want is "pure" exposures. In this case the most value could be realized by "liberating" the Cuban energy assets into a spun-out vehicle and listing it on a US exchange. It would less like creeping around the Helms-Burton Act than bulldozing that antiquated and anomalous legal oddity.

In one stroke Cuba would become instantly available to US equity investors. Meanwhile the long-suffering Sherritt shareholders would get a bonus prize that they could realise, or keep depending on their own investment objectives. Buried deep within the bowels of Sherritt this division does no-one any good.

What will make the Sherritt management see the light? Hmm.. interesting question. Anywhere else a shareholder revolt might trigger it. On past experience though, and in light of the bunker mentality that rules in the company, its more likely they would just put on their Pickelhaubers and hunker down for the fight rather than think forward as to what might be in everyone’s best interest.